BEDROCK
— DETROIT —

July 1, 2019

Via Federal eRulemaking Portal at www.regulations.gov

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: REG-120186-18 (Proposed Regulations on Investing in Qualified Opportunity Funds)

Dear Commissioner Rettig:

We write to provide comments in response to the Notice of Proposed Rulemaking, Investing in Qualified Opportunity Funds, issued May 1, 2019 (the "Proposed Regulations").[1] We appreciate the work of the staff at the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") and their commitment to prioritize guidance that will facilitate the use of the Qualified Opportunity Zone ("QOZ") tax incentives to the benefit of designated low-income communities nationwide. The Proposed Regulations, especially the rules relating to leased property and the interaction between the QOZ provisions and Subchapter K of the Internal Revenue Code,[2] represent a substantial step forward.

Detroit-based Bedrock is a full-service real estate firm specializing in acquiring, developing, leasing, financing and managing commercial and residential buildings. Since its founding in 2011, Bedrock and its affiliates have invested and committed more than $5.6 billion to acquiring and developing more than 100 properties, including new construction of ground-up developments in downtown Detroit and Cleveland totaling more than 18 million square feet. Bedrock's real estate portfolio consists of 210 office tenants and 125 retailers and restaurants in Detroit's technology-centric downtown.

Bedrock is committed to furthering the purpose of the QOZ legislation "to revitalize economically distressed communities that suffer from a lack of investment and business growth,

[1] REG-120186-18, 84 Fed. Reg. 18,652 (May 1, 2019).

[2] Unless otherwise indicated, all references to "section" are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations thereunder.

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by facilitating new incentives for investment in those areas around the country."[3] Specifically, Bedrock is dedicated to creating jobs for Detroiters and investing in job training. Over the last year, the company has invested in both the Randolph & Breithaupt Career and Technical Centers to build a pipeline of talent for Detroit's growing economy.

We believe that the purpose of the QOZ legislation is best achieved through large-scale, multi-purpose real estate development projects that transform and revitalize entire neighborhoods and communities. But this kind of transformational project cannot happen overnight. We respectfully request that Treasury and the Service consider the following revisions in the final regulations to help ensure that the rules allow such transformational real estate projects to be carried out within the QOZ framework:

1. Clarify that overlapping or sequential working capital safe harbors may be used in transformative real estate development projects that are anticipated to take longer than 31 months to complete, even if the project is not generating revenue at the end of the first 31-month safe harbor;

2. Clarify that modest amounts of property acquired from a related party or purchased before 2018 will not taint newly-developed property;

3. Respect arm's-length development agreements between related parties;

4. Clarify that self-constructed property will be treated as acquired by purchase from an unrelated party; and

5. Provide that pro rata partnership divisions will not be treated as inclusion events.

1. Final Regulations Should Clarify Time for Determining Active Conduct of a Trade or Business

The Proposed Regulations clarify that a single QOZ business may benefit from multiple overlapping or sequential applications of the working capital safe harbor to different infusions of capital.[4] However, we are concerned that Example 2 of Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(E)(2) could be read to suggest that an active trade or business must exist at the end of the first 31-month period. In particular, Example 2 describes two infusions of capital that are intended to be expended on different businesses: first, the development of a new technology; and, second, the development of a new application of existing software. The facts of this example appear to contemplate that an active trade or business relating to the new technology will exist at the end of the first working capital safe harbor period, and the Proposed Regulations do not include an example where multiple overlapping applications of the working capital safe harbor relate to developing a single trade or business.

[3] Senate Budget Committee Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115-20, at 318 (describing the purposes of the QOZ legislation).

>>> [4] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(D).

Read in this way, Example 2 could preclude transformative real estate development projects that are anticipated to take longer than 31 months to complete. For example, a project to transform a city block of condemned buildings into a multi-level, mixed-use development that includes retail, office space, work-force housing, community use space, and parking is likely to take more than 31 months to complete. However, such a transformative project is exactly the type of project that the QOZ provisions were intended to incentivize. Unlike large housing developments, these types of projects are difficult to break into multiple phases, so that each phase generates revenue after 31 months.

Final regulations could address this concern in a few different ways. First, final regulations could include an example illustrating the application of overlapping working capital safe harbors to the development of a single trade or business. This example could clarify that the active conduct of a trade or business is not required at the end of the first safe harbor period in order to meet the requirements for a QOZ business, as long as the trade or business is being actively conducted at the end of all the working capital safe harbors.

Second, final regulations could provide that ongoing real estate development constitutes the active conduct of a trade or business, even if rent or other revenues are not yet being collected. This would be a natural extension of the proposed rule that ownership and operation (including leasing) of real property (other than merely entering into a triple-net lease) is the active conduct of a trade or business.[5]

Third, final regulations could provide an extension of the 31-month safe harbor so long as a QOZ business makes continuous efforts to advance towards completion of a real estate development project. Drawing on guidance from the "beginning of construction" test for energy credits,[6] facts and circumstances indicating continuous efforts to advance towards completion of a real estate development project might include, but not be limited to:

(a) paying or incurring additional amounts included in the total cost of the property;

(b) entering into binding written contracts for the manufacture, construction, or production of components of property or for future work to construct the property;

(c) obtaining necessary permits; and

(d) performing physical work of a significant nature.

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[5] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(B)(2).

[6] *See*, *e.g.*, Notice 2018-59 § 6, 2018-28 I.R.B. 196.

2. **Final Regulations Should Clarify Treatment of Property Incorporating Property Acquired from a Related Party or Purchased Before 2018**

The QOZ rules are designed to encourage new investment into a QOZ. To achieve this end, the statutory rules generally provide that tangible property that is acquired from a related party or that is acquired before January 1, 2018 is not treated as QOZ business property.[7] However, the practical realities of major real estate development projects mean that they often incorporate a modest amount of pre-existing property or property that must be acquired from the developer or a related party. For example, the developer or a related party could contribute the land or incur certain development costs (such as site preparation, environmental remediation, and permitting) that are capitalized and added to the basis of land or a building. It would be inconsistent with the purposes of section 1400Z-2 for a modest amount of such nonqualifying property to prevent major real estate development projects from qualifying for QOZ tax incentives. As a result, final regulations should clarify that incorporating such nonqualifying property into new construction will not "taint" the new property. Instead, it should be treated as a separate asset for purposes of applying the 70-percent asset test. Final regulations should provide examples illustrating this rule.

The preamble to the Proposed Regulations notes that Treasury and the Service are studying circumstances under which property has not been purchased but has been "overwhelmingly improved" by a qualified opportunity fund ("QOF") or a QOZ business may be treated as satisfying the original use requirement.[8] We agree that, if property is overwhelmingly improved, it should lose its original taint and be treated as new property satisfying the original use requirement. Treasury and the Service have provided similar rules in other contexts, finding that, if the used property comprises no more than 20 percent of the finished construction, the entire property is treated as newly placed into service (often referred to as the "80-20 rule").[9]

3. **Final Regulations Should Respect Arm's-Length Development Agreements**

It is unclear whether fees paid by a QOZ business to a related party for the development of property will result in QOZ business property being treated as acquired from a related party. For example, if a QOZ business controlled by a real estate developer acquires property from an unrelated person after December 31, 2017 and then enters into an arm's-length development

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[7] Section 1400Z-2(d)(2)(D)(i)(I), (d)(2)(D)(iii).

[8] 84 Fed. Reg. at 18,655. Under the Proposed Regulations, original use in the zone generally commences when tangible property owned by a QOF or QOZ business is first placed in service in the zone. Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(7).

[9] *See, e.g.*, Rev. Rul. 94-31, 1994-1 C.B. 16 (replacement wind turbine qualified as "originally placed in service" even though it contained some used property, provided the fair market value of the used property was not more than 20 percent of the facility's total value (the cost of the new property plus the value of the used property)); Rev. Rul. 68-111, 1968-1 C.B. 29 (railroad locomotive constituted new section 38 property—under the pre-1986 investment tax credit provisions—where the cost of used materials and parts was not more than 20 percent of the total cost of materials and parts used in constructing the
>>> locomotive).

agreement with the related real estate developer, we do not believe that the capitalized fees should be treated as nonqualifying property, because all of the statutory requirements for QOZ business property are satisfied. Final regulations should clarify that a QOF or a QOZ business may acquire or substantially improve property pursuant to a contract with a related party without running afoul of the related party limitation, as long as the terms of the contract are arms'-length.

4. Self-Constructed Property Should Meet the "Purchase" Requirement

Consistent with the statute, the Proposed Regulations require tangible property owned by a QOF or a QOZ business to be "acquired by the [QOF or QOZ business] after December 31, 2017, by purchase as defined by section 179(d)(2) from a person who is not a related person within the meaning of section 1400Z–2(e)(2)."[10] Although self-constructed property can clearly satisfy the substantial improvement or original use requirements, it is not entirely clear, as a technical matter, whether property that is self-constructed will be considered acquired by "purchase." We believe that Congress intended to treat ground-up construction the same as other improvements and, thus, believe that self-constructed property should be treated as purchased for purposes of the QOZ rules.

Regulations under analogous Code provisions that require property to be purchased include rules that treat self-constructed property as acquired by purchase. For example, the bonus depreciation rules in section 168(k) provide that property manufactured, constructed, or produced for use by a taxpayer in its trade or business generally is deemed to be acquired by purchase on the date that the taxpayer begins manufacturing, constructing, or producing the property.[11] Final regulations should clarify that self-constructed property satisfies Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(A).

5. Partnership Divisions Should Not Be Treated as Inclusion Events

As a general rule, an inclusion event occurs to the extent that "a taxpayer receives property that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF."[12] In the context of an actual or deemed distribution by a QOF partnership, an inclusion event arises only to the extent that the value of the distributed property exceeds the partner's basis in its qualifying investment.[13] Because the fair market value of interests or assets actually or deemed distributed to a QOF partner as a consequence of a pro rata partnership division may be in excess of such partner's basis in its QOF partnership interest, such a division may result in an inclusion event under the proposed rules, even though the QOF partner has not reduced the overall equity interest in its qualifying investment.

[10] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(A), (d)(2)(i)(A),

[11] Treas. Reg. § 1.168(k)-1(b)(4)(iii)(A). *See also* section 1400N(d)(3) (adopting a similar rule for Gulf Opportunity Zones); former section 1400L(b)(20(D) (adopting similar rule for New York Liberty Zones).

[12] Prop. Treas. Reg. § 1.1400Z2(b)-1(c)(1)(ii).

[13] Prop. Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii).

In contrast, the Proposed Regulations provide that the distribution by a QOF corporation of a subsidiary in a transaction to which section 355 applies is not an inclusion event if both the distributing corporation and the controlled corporation are QOFs immediately after the final distribution, except to the extent the taxpayer receives boot. The final regulations should reconcile these conflicting rules for QOF partnerships and QOF corporations by providing that pro rata divisions of QOF partnerships pursuant to section 708 are not treated as inclusion events, as long as the two resulting partnerships are QOFs and the taxpayer's overall equity investment remains the same. Where an investor's equity interest in qualifying investments remains the same, no inclusion event is appropriate because there has been a mere change in the form of the investment.

Sincerely,

Bill Emerson
CEO, Bedrock Management Services LLC

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
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